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Statement of Position 93-6

Employers' Accounting for Employee Stock Ownership Plans

November 22, 1993

Prepared by the Accounting Standards Executive Committee

NOTE

Statements of position of the Accounting Standards Division present the conclusions of at least two thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA statements of position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this statement of position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

Statement of Position

93-6

Employers' Accounting for Employee Stock Ownership Plans

November 22, 1993

Prepared by the
Accounting Standards Executive Committee

American Institute of Certified Public Accountants

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SUMMARY

This statement of position (SOP) supersedes AICPA SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*, which was issued in December 1976. Since SOP 76-3 was issued, the reporting of transactions between employers and employee stock ownership plans (ESOPs) has become a source of accounting controversy. The importance of employers' financial reporting for ESOPs grew with increases in the number of plans and the amounts of stock held by the plans over the past decade. Furthermore, there have been significant changes in the tax and regulatory environment surrounding ESOPs and the structure and purpose of ESOPs have become more complex and diverse. Those developments called attention to the limitations of SOP 76-3, and, therefore, the Accounting Standards Executive Committee (AcSEC) initiated a project to reconsider SOP 76-3, to consider ESOP reporting issues that are not specifically addressed in the accounting literature, and to develop principles for employers' financial reporting of ESOP transactions that provide more relevant and useful information. This SOP, which provides guidance on employers' accounting for ESOPs, is a result of that project. It applies to all employers with ESOPs, both leveraged and nonleveraged.

This SOP will bring about significant changes in the way employers report transactions with leveraged ESOPs. It requires the following:

- Employers should report the issuance of new shares or the sale of treasury shares to the ESOP when the issuance or sale occurs and should report a corresponding charge to unearned ESOP shares, a contra-equity account.
- For ESOP shares committed to be released in a period to compensate employees directly, employers should recognize compensation cost equal to the fair value of the shares committed to be released.
- For ESOP shares committed to be released in a period to settle or fund liabilities for other employee benefits, such as an employer's match of employees' 401(k) contributions or an employer's obligation under a formula profit-sharing plan, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liabilities. Compensation cost and liabilities associated with providing such benefits to employees should be recognized the way they would be if an ESOP had not been used to fund the benefit.
- For ESOP shares committed to be released to replace dividends on allocated shares used for debt service, employers should report satisfaction of the liability to pay dividends when the shares are committed to be released for that purpose.

- Employers should credit unearned ESOP shares as the shares are committed to be released based on the cost of the shares to the ESOP. The difference between the fair value of the shares committed to be released and the cost of those shares to the ESOP should be charged or credited to additional paid-in capital.
- Employers should charge dividends on allocated ESOP shares to retained earnings. Employers should report dividends on unallocated shares as a reduction of debt or accrued interest or as compensation cost, depending on whether the dividends are used for debt service or paid to participants.
- Employers should report redemptions of ESOP shares as purchases of treasury stock.
- Employers should report loans from outside lenders to ESOPs as liabilities in their balance sheets and should report interest cost on the debt. Employers with internally leveraged ESOPs should not report the loan receivable from the ESOP as an asset and should not report the ESOP's debt from the employer as a liability.
- For earnings-per-share (EPS) computations, ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

This SOP, although it does not change the existing accounting for nonleveraged ESOPs, contains guidance for nonleveraged ESOPs.

This SOP also addresses issues concerning pension reversion ESOPs, ESOPs that hold convertible preferred stock, and terminations, as well as issues related to accounting for income taxes. The SOP also contains disclosure requirements for all employers with ESOPs, including those that account for ESOP shares under the grandfathering provisions.

This SOP is effective for fiscal years beginning after December 15, 1993. Employers are required to apply the provisions of the SOP to shares purchased by ESOPs after December 31, 1992, that have not been committed to be released as of the beginning of the year of adoption. Employers are permitted, but not required, to apply the provisions of the SOP to shares purchased by ESOPs on or before December 31, 1992, that have not been committed to be released as of the beginning of the year of adoption.

Employers' Accounting for Employee Stock Ownership Plans

Scope

1. This statement of position (SOP) provides guidance on employers' accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and non-leveraged. It does not address financial reporting by ESOPs.[1]

2. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

3. This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*, and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D of this SOP.

Background

4. SOP 76-3 was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

5. Since the issuance of SOP 76-3, Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of

[1] Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans.*

which are described in appendix C, were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.[2]

6. The increase in the number of ESOPs since the issuance of SOP 76-3 was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 was issued. These include the following:

- To fund a matching program for a sponsor's 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
- To raise new capital or to create a marketplace for the existing stock
- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
- To be part of the financing package in leveraged buy-outs
- To provide a tax-advantaged means for owners to terminate their ownership
- To be part of a long-term program to restructure the equity section of a plan sponsor's balance sheet
- To defend the company against hostile takeovers

7. The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

8. Employers' accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting contro-

[2] Statistics from an unpublished study completed in 1991 by the National Center for Employee Ownership, Oakland, Calif.

versy for many years. Even when SOP 76-3 was issued, there was disagreement about some ESOP issues.[3] Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3. Furthermore, SOP 76-3 does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

9. Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 and to consider current ESOP issues that are not specifically addressed in the accounting literature. AcSEC's objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

10. There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

11. The following conclusions should be read in conjunction with the "Discussion of Conclusions" beginning with paragraph 59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares.*[4] The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated

[3] Paragraph 13 of SOP 76-3 presents a minority view that disagrees with that SOP's recommendations on reporting dividends paid and earnings per share.

[4] Terms defined in the glossary are in italicized type the first time they appear in this SOP.

to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting the Release of ESOP Shares

14. ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on *allocated shares* that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (*a*) compensation cost, (*b*) dividends payable, or (*c*) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values[5] of *committed-to-be-released shares.*

15. Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP's suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are com-

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[5] Paragraph 20 of this SOP contains guidance on fair value.

mitted to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

16. Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

17. Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

18. The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace *dividends on previously allocated shares used for debt service*, employers should report

the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs 21 and 22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer's interpretation of current IRS regulations.

19. Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders' equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

20. The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer's best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer's year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

21. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

22. Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP's suspense account to participant accounts (see paragraph 18).

Reporting Redemptions of ESOP Shares

23. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan*—A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect loan*—A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan*—A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

28. For purposes of computing primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

29. Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- Whether convertible preferred shares held by an ESOP should be considered common stock equivalents
- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods' EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute EPS and does not address all possible EPS questions that may arise. Accounting Principles Board

(APB) Opinion No. 15, *Earnings per Share*; the AICPA's accounting Interpretations of that Opinion; and illustrations 4 and 5 in appendix A of this SOP provide additional guidance.

30. *Common Stock Equivalents.* APB Opinion No. 15 requires that a convertible security, which at the time of issuance has terms that make it for all practical purposes substantially the equivalent to a common stock, should be regarded as a common stock equivalent. For convertible preferred stock not held by an ESOP, an effective yield test is applied to the securities at the time of issuance to determine whether the securities should be considered common stock equivalents. However, the terms of convertible preferred shares held by ESOPs generally differ from other convertible preferred stock in two ways:

a. Convertible preferred shares held by ESOPs generally cannot remain outstanding indefinitely.

b. ESOP participants cannot withdraw their convertible preferred shares from the plan; the terms generally require participants to redeem the shares with the employer or convert the shares to common stock when participants withdraw their account balances from the ESOP plan. (Whether a participant chooses redemption or conversion depends on the value of the employer's common stock in relation to the stated minimum value of the convertible preferred stock.)

ESOP shares with such characteristics should always be considered common stock equivalents. However, if the convertible preferred shares held by an ESOP may be withdrawn from the plan and sold to someone other than the employer or other ESOP participants, the employer should apply the effective yield test to determine whether the shares should be considered common stock equivalents.

31. *Number of Shares Outstanding.* Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. For ESOP shares considered common stock equivalents, the number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for both primary and fully diluted EPS if the effect is

dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for both primary and fully diluted EPS.

32. When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares or a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash.[6] In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (*a*) the shares issuable at the stated conversion rate and (*b*) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed for primary earnings based on the ratio of (*a*) the average fair value of the convertible stock or, if greater, its stated minimum value, to (*b*) the average fair value of the common stock. For fully diluted EPS, the ratio should be (*a*) the end-of-period fair value of the convertible stock or, if greater, the stated minimum value, to (*b*) the end-of-period value of the common stock, if that ratio is more dilutive than the primary EPS ratio. The appropriate ratios should then be applied to the shares issuable at the stated conversion rate to determine the number of shares issuable on assumed withdrawal.

33. *Adjustments to Earnings.* Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensa-

[6] Financial Accounting Standards Board (FASB) Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations*, uses such a presumption for stock appreciation rights and other variable plan awards.

tion cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

34. *Changes in Conversion Rates.* In consonance with paragraphs 56 through 58 of APB Opinion 15, prior period EPS should not be restated for changes in the conversion rates.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, requires that difference to be included in the employer's income when the debt is extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock

transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

Nonleveraged ESOPs

40. An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP's fiscal year.

Reporting Purchase of Shares by ESOPs

41. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

Reporting Dividends on ESOP Shares

42. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Reporting Redemptions of ESOP Shares

43. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Earnings per Share

44. All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer's EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs 29 to 34 of this SOP for leveraged ESOPs should be considered.

Pension Reversion ESOPs

45. An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

46. If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

47. Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a

suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

48. If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs 14 to 18).

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

49. For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (*a*) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (*b*) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* Similar differences arise from employee stock options. Paragraph 36e of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders' equity.

50. In accordance with paragraph 36e of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders' equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders' equity to the extent of previous

credits to shareholders' equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

51. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36f of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders' equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36f of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

52. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

Disclosures

53. An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in this SOP is required (see paragraphs 54 and 55), the accounting policies for both blocks of shares shall be described.

c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs 54 and 55).

e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP's cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs 55 and 56).

f. The existence and nature of any repurchase obligation, including disclosure of the fair value[7] of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

Effective Date and Transition

54. This SOP is effective for fiscal years beginning after December 15, 1993. The SOP should be adopted in the first interim period of an employer's fiscal year. Early application is permitted. Prospective application of the guidance in the SOP is required for shares acquired by ESOPs after December 31, 1992 (new ESOP shares) but not yet committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach. Restatement of previously issued annual financial statements is not permitted.

55. Application of all of the guidance in this SOP may be elected, and is encouraged, for shares acquired by ESOPs on or before December 31, 1992 (old ESOP shares). (Selective adoption of the guidance in this SOP is not permitted.) However, employers with ESOPs that do not adopt this SOP for shares held by ESOPs on December 31, 1992, should make all of the applicable disclosures required by paragraph 53. Employers electing to adopt this SOP for old ESOP shares in the first fiscal year beginning after December 15, 1993, or in the preceding year should apply the SOP prospectively to

[7] See paragraph 20 for guidance on fair value.

the old ESOP shares that have not yet been committed to be released as follows:

- Employers that applied the shares allocated method described in EITF Issue No. 89-8[8] should apply this SOP prospectively to those shares that have not yet been committed to be released as of the beginning of the year in which the SOP is adopted. No cumulative effect adjustment should be reported under this approach.
- Employers that did not apply the shares allocated method described in EITF Issue No. 89-8 should recognize as an expense in the period of adoption the difference between (*a*) the cumulative ESOP expense recognized prior to the period of adoption of this SOP and (*b*) the cumulative expense that would have been recognized prior to the period of adoption of this SOP under the shares allocated method ([total shares committed to be released multiplied by cost of the shares to the ESOP] less cumulative dividends on ESOP shares). That difference should be reported as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, by including the cumulative effect of the change in income and crediting unearned ESOP shares in the period the SOP is first applied. However, pro forma disclosures are not required.

Restatement of previously issued annual financial statements is not permitted.

56. Employers electing to adopt this SOP for old ESOP shares in a fiscal year later than the first fiscal year beginning after December 15, 1993, should apply the SOP retroactively through restatement of previously issued financial statements for all years beginning after December 15, 1993. The restatement of the financial statements for the first year beginning after December 15, 1993 (the earliest year restated) should be performed in accordance with paragraph 55. If the earliest year restated is not presented in the financial statements,

[8] In EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*, the EITF reached a consensus that ESOP shares purchased after December 15, 1989, should be accounted for under the shares allocated method, which is described in that consensus. However, the consensus allows employers with shares purchased before December 15, 1989, to account for such shares under their current methods in certain circumstances.

the beginning balance of retained earnings (and, if necessary, additional paid-in capital) for the earliest year presented should be adjusted for the effect of the restatement as of that date.

57. For employers that adopt this SOP in a period other than the period the ESOP shares were purchased, certain shares considered outstanding for EPS computations in prior years will no longer be considered outstanding for EPS purposes in the year of adoption. As noted above, restatement is not permitted, however, such employers should disclose the number of shares considered outstanding for EPS purposes in prior periods that are no longer considered outstanding in the current period.

58. An employer may have both (1) old ESOP shares for which it does not adopt the guidance in this SOP and (2) new ESOP shares for which the guidance in this SOP is required. The measure of compensation cost for the old and new shares in this circumstance will differ. The identification of the shares released each year for financial reporting purposes should be the same as the identification of the shares released for ERISA purposes.

Discussion of Conclusions

59. This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

Leveraged ESOPs

60. AcSEC believes that all of the specific conclusions about employers' accounting for leveraged ESOP transactions follow from AcSEC's fundamental conclusion that the accounting for an ESOP's debt (financing element) should be separate from the accounting for an ESOP's shares (defined contribution element). Although the financing and defined contribution elements of leveraged ESOPs are related, each should be analyzed and reported separately, and the principles for reporting one element should not affect the principles for reporting the other. Under this SOP, each element is reported in

accordance with its substance as it would be reported if it occurred as a separate transaction.

Accounting for Debt and Shares at the Inception of the ESOP

61. When a leveraged ESOP is established, it borrows money and buys employer shares for cash. However, because the employer is the ultimate source of the cash to repay the debt and is the beneficiary of the financing, AcSEC believes that the substance of the transaction is that the cash is not a consideration to the employer for the shares but rather proceeds from a borrowing. The consideration to be received by the employer for placing the shares in the ESOP trust is future employee services. In fact, the ESOP acquires the shares before the employees have performed the services for which the shares are to compensate them.

62. AcSEC believes that because the shares transferred from the employer to the ESOP when the ESOP is established are not exchanged for a receipt of assets or services, or for a reduction of liabilities, total shareholders' equity should remain unchanged. The transaction should be reported only as a change within equity until the shares are committed to be released for allocation to participant accounts for services provided. Furthermore, AcSEC believes that even if a leveraged ESOP buys shares on the market rather than from the employer and, therefore, the employer has no direct capital stock transaction and no direct cash inflow when establishing a leveraged ESOP, the employer should treat it as a leveraged ESOP. Such a situation is analogous to an employer selling newly acquired treasury stock to its ESOP. Therefore, shareholders' equity should be reduced by reporting the amount of the stock the ESOP acquires as unearned ESOP shares. Either cash or debt would be credited, depending on whether the ESOP is internally or externally leveraged.

63. For employers with internally leveraged ESOPs (indirect and employer loans), AcSEC notes that the ESOP's note payable does not represent an obligation of the employer to transfer resources to the ESOP and that the employer's note receivable does not represent a claim by the employer on the ESOP's resources. Therefore, AcSEC concluded they should not be reported by the employer as a liability and as an asset, respectively.

Recognition and Measurement of Release of Shares

64. AcSEC believes its conclusions on recognition and measurement follow from its conclusions that the debt and shares related to ESOP transactions should be accounted for separately. The substance of an employer's cash contribution to an ESOP is that the cash contribution is used for the payment of debt service on the employer's debt. It is the release of shares, not the employer's cash contribution, that represents the compensation of participants in connection with the defined contribution plan. AcSEC's objective is that the accounting reflect the terms of the exchange transactions that take place between an employer that provides compensation and the employees who render services in exchange for that compensation. To do that, AcSEC considered how the ESOP shares are used.

65. A key concept introduced in this SOP is that employers may use ESOP shares for different purposes: to compensate employees directly, which was the primary use when SOP 76-3 was issued; to settle liabilities for employee benefits, such as an employer's match under a 401(k) plan, that arise outside of the ESOP; or to replace dividends on allocated ESOP shares that are used for debt service. The accounting in each of those situations is discussed below.

66. *Shares Used to Directly Compensate Employees.* For ESOP shares used to compensate employees directly, AcSEC addressed two issues: (*a*) when to record compensation and (*b*) when to measure compensation. AcSEC concluded that employers should record compensation when the shares are committed to be released, because AcSEC believes that is when the exchange between the employer and the employees of employer stock for services rendered occurs. Furthermore, AcSEC believes that the release of shares in a leveraged ESOP is analogous to the employer's contribution to a nonleveraged ESOP.

67. In reaching its conclusion on when to record compensation, AcSEC also considered whether either the point at which ESOP shares are allocated or at which employees become vested in ESOP shares is significant for accounting purposes, but rejected both of those recognition dates.

68. AcSEC notes that allocation is merely a mechanical process of assigning the released shares to individual participant accounts

within the ESOP trust based on a known formula involving compensation, seniority, or both. AcSEC, therefore, believes that the allocation of shares is not significant for accounting purposes in recognizing compensation cost.

69. Furthermore, AcSEC believes that vesting provisions, which determine *vested shares,* are not the most meaningful way for employers with ESOPs to relate compensation cost to services performed. ESOPs are defined contribution plans in which participants receive regular periodic awards subject to vesting provisions. AcSEC believes that, in plans such as ESOPs in which employees receive regular, periodic awards, the shares released each period are earned by providing that period's service even though the shares may not vest until later.[9] Furthermore, FASB Statement No. 87, *Employers' Accounting for Pensions,* states that for defined contribution plans, the pension cost should equal the contribution called for in the period. Vesting is not a factor in recognizing compensation costs for defined contribution pension plans.

70. One of the most significant issues addressed in this SOP is the date on which compensation cost should be measured. Under current practice, compensation cost is measured at the date the ESOP purchases the shares, based on the ESOP's purchase price. AcSEC believes that compensation cost should be measured at the dates shares are committed to be released based on their current fair value, for the following reasons:

- APB Opinion 25, *Accounting for Stock Issued to Employees,* states that the measurement date for compensation is the first date on which the number of shares that an individual employee is entitled to receive is known. For ESOPs, the number of shares individual employees will receive is not determinable until the shares are committed to be released. Furthermore, paragraph 11e specifically notes that transferring shares to a trustee does not

[9] Allocated shares that have not vested may be forfeited by certain participants and reallocated to others. Under this SOP, the reallocation of forfeited shares does not result in a cost in the period the shares are reallocated. In fact, the increase or decrease in the fair value of such shares between the date the shares were originally released and the date they are reallocated may affect the number of shares needed to satisfy the employer's obligation to employees. Nevertheless, AcSEC believes that the costs associated with maintaining the records necessary to determine the effects of forfeitures on the employer's obligations and costs would exceed the benefits derived.

establish a measurement date for measuring compensation, even if the transfer is irrevocable, unless the identity of the recipient is known. (The general definition of measurement date in APB Opinion 25 supports the allocation date as the measurement date for a leveraged ESOP. However, AcSEC believes the special situations described in paragraphs 11a and 11c of APB Opinion 25 support measurement of compensation at the date shares are committed to be released. The total number of shares committed to be released for the current year's employee service is known prior to allocation and the shares must be allocated to individual employees' accounts as of the end of the ESOP's fiscal year.) Although APB Opinion 25 was issued before SOP 76-3, AcSEC believes that, because of the significant changes in ESOPs since SOP 76-3 was issued, the accounting in that SOP contrary to APB Opinion 25 is no longer appropriate.

- Using the fair value of the shares when the shares are committed to be released more accurately reflects the value of the services received by the employer. AcSEC believes an employer that sponsors a leveraged ESOP has entered into a transaction similar to an employer that borrows funds to buy treasury stock and later exchanges those shares with employees for services. Neither transaction should fix the employer's cost of providing employee benefits in the future.

- The risks and rewards of ownership of the shares rests with the employer until the shares are committed to be released, because of the large degree of control employers have (*a*) over how the ESOP debt will be repaid (for example, in some situations, an employer may prepay or refinance debt to achieve certain compensation goals) and (*b*) over an employee's compensation (for example, in some situations, an employer has the ability to change other parts of an employee's compensation package in reaction to changes in the value of the shares being released to maintain an overall competitive level of compensation).

- Measuring compensation based on current fair value conforms the accounting for leveraged and nonleveraged ESOPs. Instead of forming a leveraged ESOP, an employer could borrow and use the funds to buy treasury stock. Then, as the debt is repaid, the employer could contribute the treasury shares to a nonleveraged ESOP. Compensation cost would be measured and recognized based on the fair value of the shares when they are contributed or committed to be contributed to the nonleveraged ESOP. AcSEC believes that a leveraged ESOP and the transaction described in this paragraph have more similarities than differences, and that compensation should be measured in the same way for both.

71. *Shares Used to Fund Liabilities for Other Employee Benefits.* AcSEC believes the employer's cost and liabilities for employee benefits that are funded with ESOP shares should be measured and recognized in the same way as if some other means of funding were used. The shares committed to be released represent funding or settlement of the employer's obligation for the benefits. To illustrate, assume the following facts about an employer with a leveraged ESOP:

- The ESOP shares are used to fund an employer match under its 401(k) savings plan equal to 50 percent of employee contributions.
- The market value of ESOP shares on the release date is used to determine (*a*) how many shares are allocated to particular participants and (*b*) whether the employer must provide cash or additional shares to fund the difference between the market value of the shares committed to be released and the employer's obligation under the savings plan.
- In period 1, employees contribute $1,000 to their 401(k) accounts and, accordingly, the employer must match $500.
- The market value of shares committed to be released to those employee accounts is $450; the cost of the shares committed to be released is $425.
- The employer issues additional shares with a fair value of $50 to the ESOP (*top-up shares*).

Under current practice for ESOPs, the employer would report compensation cost of $475 ($425 cost of shares plus $50 top-up), although its obligation to employees is $500 (50 percent of the employee contribution). Under this SOP, the employer would report compensation cost of $500, which is the amount AcSEC believes more accurately reflects the substance of the transaction.

72. *Shares Used to Replace Dividends.* Similarly, AcSEC believes that for ESOP shares used to replace dividends on allocated shares that were used for debt service, the dividend payable is measured and recognized in the same way as if it were paid in cash. The shares

committed to be released represent funding or settlement of the dividend payable.

Dividends

73. Legally, dividends on allocated shares belong to ESOP participants and are not controlled by employers. Although employers may use those dividends to pay debt service, they must allocate shares to participant accounts to replace such dividends. AcSEC believes that dividends on allocated shares have the attributes of dividends, because employers have a liability to pay such dividends to an identifiable outside party in proportion to shares of ownership. Therefore, AcSEC believes that dividends on allocated shares should be charged to retained earnings.

74. Although legally the dividends on unallocated ESOP shares belong to the ESOP, employers control the use of such dividends, the shares have not been exchanged for employee services, and are not considered outstanding for EPS purposes. The use of dividends on unallocated shares is usually determined by the employer when the ESOP is established. The employer may decide to use such dividends to compensate participants by adding the value of the dividends to participant accounts. Or, more commonly, the employer decides to use such dividends to pay debt service on the ESOP's debt, which the employer has reported as a liability. In all those situations, the employer controls, and benefits from, the use of the dividends on unallocated shares.

75. If the employer decides to pay the dividends to participants or add the value of the dividends to participant accounts, no linkage exists within the ESOP trust between the ownership of the shares and the amount of dividends paid to participants.[10] AcSEC concluded that such dividends lack the normal attributes of dividends and that the employers are providing additional compensation to participants. Accordingly, such dividends should be charged to compensation cost.

76. If the employer decides to use the dividends to pay debt service, there is no requirement that the employer replace those divi-

[10] Under the IRC, if employers choose to pay dividends on suspense account shares to participants or to add those dividends to participant accounts, the allocation of the dividends must be nondiscriminatory among plan participants.

dends or allocate additional shares to participants. Therefore, from the employer's perspective, the only economic event that has occurred when the employer uses dividends on ESOP suspense shares to pay debt service is that cash is transferred to a creditor of the employer (indirect or direct loans) for debt service or is retained by the employer (employer loans); no distribution to shareholders has occurred. AcSEC concluded that such dividends lack the normal attributes of dividends and should be reported as reductions of debt and interest payable.

77. Under this SOP, dividends on committed-to-be-released-but-unallocated shares are not charged to retained earnings although, for financial reporting purposes, such shares have been exchanged for employee service and are considered outstanding for EPS computations. However, because employers do not relinquish control over the use of the dividends on ESOP shares until the shares are allocated, AcSEC believes that dividends on committed-to-be-released-but-unallocated shares should be treated the same way as dividends on other unallocated shares. AcSEC also notes that the treatment of dividends in other situations does not necessarily correspond with whether the shares are outstanding for EPS purposes. For example, in practice, dividends on restricted shares issued in conjunction with a restricted stock compensation plan are charged to retained earnings although the shares may be only partially outstanding for EPS purposes under the treasury stock method.

Unearned ESOP Shares

78. AcSEC considered whether the contra-equity account representing unearned ESOP shares should be adjusted to fair value at each reporting date with a corresponding entry to paid-in-capital. However, because the fair value of unearned ESOP shares must be disclosed and there would be no effect on equity, AcSEC decided against such a requirement.

Redemption of Shares

79. AcSEC believes that employer redemptions of ESOP shares from participants are purchases of treasury stock, even if there is a put option on the shares, and therefore believes that compensation cost should not be adjusted as the value of allocated shares changes. Employers whose shares are not readily tradable are required to give

participants a put option, often called a liquidity put. AcSEC notes that such put options are given and shares are purchased from participants to comply with legal requirements and to make a market for the employer's shares. For employers whose shares are readily tradable, AcSEC views the cash redemption options primarily as a convenience to participants, to save them the brokerage commissions involved in the sale of what often may be small holdings and odd lots. Furthermore, ESOPs are nondiscriminatory benefit plans for substantially all employees, and participants may redeem their shares only at times permitted by law, typically on termination, hardship, or retirement. Accordingly, AcSEC believes that the existence of such options does not change the nature of an ESOP to that of a cash plan as described in paragraph 11g of APB Opinion 25.

Earnings per Share

80. AcSEC believes that ESOP shares committed to be released and, accordingly, exchanged for employee services, are the same as other outstanding shares and should be treated as outstanding for EPS purposes. By contrast, AcSEC believes that ESOP shares that have not been committed to be released and, accordingly, not exchanged for employee services, should not be treated as outstanding for EPS purposes. AcSEC believes that this conclusion is consistent with its conclusion on reporting the release of shares in that the shares are not treated as issued until they are committed to be released.

81. AcSEC believes that ESOP shares that have not been committed to be released are analogous to unpaid stock subscriptions, and the related consideration the employer will receive is future employee services rather than cash proceeds. Accordingly, AcSEC also considered whether the treasury stock method should be used to determine EPS similar to the way it is applied to unpaid stock subscriptions. However, AcSEC rejected the treasury stock method in favor of the released shares outstanding method, because the number of shares outstanding would be the same under either method and the released shares outstanding method is simpler to understand and apply.

ESOPs That Hold Convertible Preferred Stock

82. *Common Stock Equivalence.* Unlike conventional convertible preferred shares, convertible preferred shares held by an ESOP

generally cannot remain outstanding indefinitely. Convertible preferred stock ESOPs generally are structured so that employees cannot withdraw the convertible preferred stock from the plan. When participants retire or otherwise become eligible to withdraw their account balances, they have the right to obtain common stock. (They may also have the right to obtain cash, which is discussed below.) Although the unique characteristics of convertible preferred stock held by an ESOP are not specifically addressed in APB Opinion 15, AcSEC believes that the shares are common stock equivalents, because the condition precedent to the issuance of common stock for shares that have been committed to be released is merely the passage of time until employees retire or otherwise become eligible to withdraw their account balances. In addition, although most employees will not retire or otherwise become eligible to withdraw their account balances within ten years of a balance sheet date, the ESOP trustees or the participants generally have the right to convert the preferred shares to common during that ten-year period. Accordingly, AcSEC believes the provisions in paragraph 58 of APB Opinion 15 about conversion rights that are not effective until after ten or more years generally do not apply to ESOP convertible preferred shares.

83. *Computation of Shares Issuable on Assumed Conversion.* If participants withdrawing shares from their accounts are entitled to additional common shares because the fair value or the stated minimum value of the convertible preferred shares exceeds the fair value of the common shares issuable upon conversion, AcSEC believes that the additional shares should be assumed issued in the if-converted EPS computations. Some believe that because employers may have the ability to pay cash to the ESOP trustee (who would then buy employer common stock on the market for those participants who choose common stock) instead of issuing common stock to participants directly, the additional shares should be excluded from the EPS computations. However, AcSEC believes that any issuer of convertible securities has the ability to buy shares on the market to satisfy conversion requirements and that such ability does not change the requirement to reflect the potential dilution from the convertible securities in EPS computations.

84. ESOP convertible preferred stock has unique attributes, which AcSEC believes make it similar to convertible securities with variable conversion rates. AcSEC's recommendations in this section

are based on that analogy. Because the varying conversion rates are purely a function of changes in fair values, which are unknown before they occur, AcSEC concluded that the additional shares issuable should be computed based on current period fair values for both primary and fully diluted EPS computations.

85. *Adjustment of Earnings Applicable to Common Stock.* When dividends on allocated ESOP shares are used to pay debt service, participants receive their dividends in shares rather than in cash. In the normal situation, if the preferred stock were converted to common stock, the common stock dividend would be less than the preferred stock dividend, the proportion of committed-to-be-released shares needed to replace dividends on allocated shares would be smaller after the assumed conversion, and the proportion of committed-to-be-released shares used to compensate participants for services would be greater after the assumed conversion. AcSEC believes the availability of a greater proportion of released shares to compensate participants is a nondiscretionary adjustment, as described in paragraph 51 of APB Opinion 15. Accordingly, earnings applicable to common stock in the if-converted computations should reflect the additional compensation cost that would arise from the assumed conversion. (Illustrations 4 and 5 of appendix A include this calculation.)

86. AcSEC believes that cash dividends on allocated ESOP shares paid to participants or added to participant accounts should be treated the same way as dividends on non-ESOP convertible preferred stock, and, accordingly, concluded that adjustment of compensation cost for EPS computation purposes is unnecessary.

87. Dividends on unallocated ESOP shares used to pay debt service are not treated as dividends for accounting purposes and, therefore, do not affect the if-converted EPS computations.

88. Dividends on unallocated ESOP shares paid to participants or added to participant accounts are treated as compensation cost. That use of dividends and, consequently, the compensation provided to participants, is discretionary when the ESOP is established. Accordingly, AcSEC believes that the compensation cost arising from those dividends should not be adjusted in the if-converted EPS computations.

Terminations

89. Although IRS and ERISA rules make it difficult, and often uneconomical, to terminate leveraged ESOPs and generally require a valid business reason—such as significant shrinkage in the work force or bankruptcy—for doing so, terminations and curtailments of ESOP plans occasionally occur. AcSEC believes that the conclusion that terminations or curtailments involving an ESOP's suspense shares should be accounted for as treasury stock transactions is consistent with the basic premise of this SOP—that the shares and debt should be accounted for separately. Another important consideration was that suspense shares are not considered outstanding for EPS computations.

90. The accounting for terminations recommended in this SOP would result in a debit to paid-in capital when the fair value of the shares at the termination date is less than the cost of the shares to the ESOP and a credit to paid-in capital when the fair value of the shares at the termination date is more than the cost of the shares to the ESOP. AcSEC believes those debits or credits to equity are analogous to losses and gains on the employer's own stock, which should be excluded from income. Under this SOP, differences between the fair value and cost of ESOP shares used to settle employer liabilities are debited and credited to shareholders' equity. An ESOP termination is effectively the use of ESOP shares to settle the employer's liability for ESOP debt. Even if an employer has an internally leveraged ESOP with no related outside debt, AcSEC believes the reacquisition of the ESOP shares should be treated as a purchase of treasury stock because, under this SOP, the employer does not report the ESOP's note payable and does not report a note receivable from the ESOP, and the suspense shares have neither been considered outstanding for EPS nor exchanged for employee services.

91. AcSEC provides the following example to illustrate the point. An ESOP borrows $1,000 and acquires 100 shares of employer stock for $10 per share (market price on the date acquired). The market price subsequently drops to $6 per share, and the employer decides to terminate its ESOP when there are 80 shares in suspense and an $800 debt balance. Accordingly, the employer would have to contribute an additional $320 ($800 less $6 multiplied by 80 shares) to retire

the ESOP debt. AcSEC believes that the additional contribution is a result of a change in the value of the employer's shares, not of a change in the debt obligation. Therefore, the $320 should be charged to paid-in capital, not to income as an extinguishment loss or compensation expense. AcSEC believes the accounting treatment recommended for terminations is analogous to any company borrowing cash to buy shares of its own stock and later selling those shares to obtain cash to repay the debt. If the proceeds from the sale of the shares is insufficient to repay the debt because the fair value of the shares declined between the purchase and sale dates, the company will have to use additional cash to repay the debt. Such a transaction would have no impact on the company's income.

Nonleveraged ESOPs

92. Although this SOP would not change how employers with nonleveraged ESOPs account for ESOP transactions, AcSEC believes it is helpful to include a discussion of nonleveraged ESOPs. The accounting described in this SOP for employers with nonleveraged ESOPs is based on the fact that nonleveraged ESOPs are defined contribution pension plans covered by FASB Statement No. 87. Therefore, the compensation cost for the period should generally equal the contribution called for in the period. The shares or cash that an employer contributes or commits to contribute to a nonleveraged ESOP for a period is consideration for employee services rendered during that period.

Pension Reversion ESOPs

93. If the excess assets from a pension reversion are used to purchase ESOP shares, the shares in excess of the amount that may be allocated to participants in the year of the reversion are held in a suspense account and allocated in future years. The suspense account shares arising from a pension reversion do not collateralize a borrowing, and the release of such shares is not based on debt service payments. However, in most other respects, such suspense account shares are the same as the suspense account shares in a leveraged ESOP, and, accordingly, AcSEC concluded that they should be accounted for in the same way as suspense account shares of leveraged ESOPs.

Income Taxes

94. Although FASB Statement No. 109, *Accounting for Income Taxes*, does not explicitly address how to treat differences between the fair value and the cost of ESOP shares committed to be released, it does address expenses for employee stock options recognized differently for financial reporting and tax purposes, which AcSEC believes is analogous to ESOPs. The FASB decided to make no changes to paragraph 17 of APB Opinion 25, which prohibits reporting the related tax effect of such differences as a part of income and requires that they be reported as charges or credits directly to related components of shareholders' equity.

Disclosures

95. AcSEC notes that the disclosures in paragraph 53f related to repurchase obligations are a minimum requirement. AcSEC recognizes that employers may wish to disclose additional information about the obligation, particularly information about the timing of payments.

Transition

96. AcSEC believes that transition, to a significant extent, is a practical matter. A major objective of transition is to minimize implementation costs and to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this SOP and consistency among reporting entities.

97. In deciding to grandfather shares held by ESOPs as of December 31, 1992, AcSEC was most influenced by its perception that it would be unfair to employers with existing ESOPs to change their accounting for ESOPs currently in place. The decision to establish an ESOP is complex and involves the consideration of many factors, such as IRS and ERISA regulations, employee compensation matters, and possible other uses of debt proceeds, as well as how the ESOP will affect earnings during its term. ESOPs are long-term undertakings, they are costly to establish, and they cannot be undone easily. For many employers, the accounting treatment, which was

covered in SOP 76-3, was an important consideration in establishing their ESOPs.

Minority View

Four AcSEC members dissent to the issuance of this SOP, because they believe that fair value of shares released should not be used to measure compensation cost of certain ESOPs. The dissenters believe there are two types of ESOPs, as follows:

- *Type I*—Shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares released is not a factor in determining the number of shares to be allocated to employees. These ESOPs are typical of the ESOPs that commonly existed at the time SOP 76-3 was issued.
- *Type II*—Shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

The dissenters believe that Type I ESOPs should be excluded from the scope of the SOP because the current accounting guidance for Type I ESOPs continues to be relevant and the costs of applying the SOP to Type I ESOPs are not justified. They believe this SOP on employers' accounting for ESOP transactions should cover only the ESOPs for which there is concern that the current accounting is inappropriate. The dissenters believe that the measurement date to recognize compensation expense for Type I ESOPs should continue to be the date the shares are purchased by the ESOP, because that is when the risks and rewards associated with the value of the ESOP shares are transferred from the employer to employees. In contrast, the dissenters agree with the accounting in this SOP for Type II ESOPs.

APPENDIX A

Illustrations

This appendix contains illustrations of the requirements of this SOP for employers with the following kinds of ESOPs:

- *Illustration 1*—A common-stock leveraged ESOP with a direct loan
- *Illustration 2*—A common-stock leveraged ESOP used to fund the employer's match of a 401(k) savings plan with an indirect loan
- *Illustration 3*—A common-stock nonleveraged ESOP
- *Illustration 4*—A convertible-preferred-stock leveraged ESOP with a direct loan
- *Illustration 5*—A convertible, preferred-stock, leveraged ESOP used to fund a 401(k) savings plan with an employer loan

The illustrations do not address all possible circumstances that may arise in applying the SOP. The illustrations are for annual reporting periods and, accordingly, do not demonstrate the application of the SOP to interim financial statements. However, depending on the circumstances, many of the journal entries illustrated would be made for interim financial statements.

Common Stock Leveraged ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company A establishes a leveraged ESOP as follows:

- The ESOP borrows $1,000,000 from an outside lender at 10 percent for five years and uses the proceeds to buy 100,000 shares of newly issued common stock of the sponsor for $10 per share, which is the market price of those shares on the date of issuance.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The year-end and average market values of a share of common stock follow:

Table 1-a

Year	*Year-end*	*Average*
1	$11.50	$10.75
2	9.00	10.25
3	10.00	9.50
4	12.00	11.00
5	14.40	13.20

- The common stock pays normal dividends at the end of each quarter of 12.5 cents per share ($50,000 for the ESOP's shares each year). Accordingly, in this illustration, the average fair value of shares is used to determine the number of shares used to satisfy the employers' obligation to replace dividends on allocated shares used for debt service.
- Principal and interest are payable in equal annual installments at the end of each year. Debt service is as follows:

Table 1-b

Year	*Principal*	*Interest*	*Total Debt Service*
1	$ 163,800	$100,000	$ 263,800
2	180,200	83,600	263,800
3	198,200	65,600	263,800
4	218,000	45,800	263,800
5	239,800	24,000	263,800
	$1,000,000	$319,000	$1,319,000

- The number of shares released each year is as follows:

Table 1-c

Year	*Dividends*	*Compensation*	*Total*
1	0	20,000	20,000
2	976	19,024	20,000
3	2,105	17,895	20,000
4	2,727	17,273	20,000
5	3,030	16,970	20,000

The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares by the average fair value of a share of common stock (for year 2: $10,000 divided by $10.25 equals 976 shares). In this illustration, the remaining shares are released for compensation (for year 2: 20,000 less 976 equals 19,024 shares).

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participant accounts the following year. Shares released and allocated follow:

Table 1-d

	Cumulative Number of Shares		*Average Shares*	*Year-End Suspense*
Year	*Released*	*Allocated*	*Released*	*Shares*
1	20,000	0	10,000	80,000
2	40,000	20,000	30,000	60,000
3	60,000	40,000	50,000	40,000
4	80,000	60,000	70,000	20,000
5	100,000	80,000	90,000	0

- Income before ESOP-related charges is as follows:

Table 1-e

Year	*Income*
1	$1,800,000
2	1,900,000
3	2,000,000
4	2,100,000
5	2,200,000

- All interest cost and compensation cost are charged to expense each year.
- Excluding ESOP shares, 1,000,000 shares are outstanding on average each year.
- Company A follows FASB Statement No. 109.

- Company A's combined statutory tax rate is 40 percent each year.
- Company A's only book/tax differences are those associated with its ESOP.
- No valuation allowance is necessary for deferred tax assets.

Results of Applying SOP

The following table sets forth Company A's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*
1	$ 163,800	$ (200,000)	$(15,000)	$ 0	$100,000	$215,000	$ (263,800)
2	180,200	(200,000)	(5,000)	10,000	83,600	195,000	(263,800)
3	198,200	(200,000)	10,000	20,000	65,600	170,000	(263,800)
4	218,000	(200,000)	(20,000)	30,000	45,800	190,000	(263,800)
5	239,800	(200,000)	(64,000)	40,000	24,000	224,000	(263,800)
Total	$1,000,000	$(1,000,000)	$(94,000)	$100,000	$319,000	$994,000	$(1,319,000)

Notes:

(1) See table 1-b.

(2) Total number of shares released for year (20,000) multiplied by the cost per share to ESOP ($10).

(3) Total number of shares released for year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to ESOP ($10). [Year 1: 20,000 shares multiplied by ($10.75–$10.00)]

(4) Cumulative number of allocated shares (see table 1-d) multiplied by the dividend per share. [Year 2: 20,000 shares multiplied by $.50]

(5) Number of shares released for compensation (see table 1-c) multiplied by the average fair value per share for the period (see table 1-a). The amounts in this column have been rounded.

(6) The cash disbursed each year is comprised of $213,800 contribution and $50,000 in dividends.

Journal Entries

Company A would record journal entries from inception through year 5 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000

[To record the ESOP's loan]

Unearned ESOP shares (equity)	1,000,000	
Common stock and paid-in capital		1,000,000

[To record the issuance of 100,000 shares to the ESOP at $10 per share]

Year 1

Interest expense	100,000	
Accrued interest payable		100,000

[To record interest expense]

Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, none of which is charged to retained earnings in year 1, and $213,800 supplemental cash contribution to the ESOP)]

Compensation expense	215,000	
Paid-in capital		15,000
Unearned ESOP shares		200,000

[To record release of 20,000 shares at an average fair value of $10.75 per share (shares cost ESOP $10)]

Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480

[To record income taxes for year 1 (See tax computations following journal entries)]

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, $10,000 of which is charged to retained earnings in year 2, and $213,800 supplemental cash contribution to the ESOP)]

(Continued)

Retained earnings	10,000	
Dividends payable		10,000

[To record declaration of $.50 per share dividend on the 20,000 allocated shares]

Compensation expense	195,000	
Dividends payable	10,000	
Paid-in capital		5,000
Unearned ESOP shares		200,000

[To record release of 20,000 shares (19,024 for compensation and 976 for dividends) at an average fair value of $10.25 per share (shares cost ESOP $10 per share)]

Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654,480

[To record income taxes for year 2 (See tax computations following journal entries)]

Year 3

Interest expense	65,600	
Accrued interest payable		65,600

[To record interest expense]

Accrued interest payable	65,600	
Debt	198,200	
Cash		263,800

[To record debt payment]

Retained earnings	20,000	
Dividends payable		20,000

[To record declaration of $.50 per share dividend on the 40,000 allocated shares]

Compensation expense	170,000	
Dividends payable	20,000	
Paid-in capital	10,000	
Unearned ESOP shares		200,000

[To record release of 20,000 shares (17,895 for compensation and 2,105 for dividends) at an average fair value of $9.50 per share (shares cost ESOP $10 per share)]

Deferred tax asset	720	
Provision for income taxes	697,760	
Paid-in capital		4,000
Income taxes payable		694,480

[To record income taxes for year 3 (See tax computations following journal entries)]

Year 4

Interest expense	45,800	
Accrued interest payable		45,800
[To record interest expense]		
Accrued interest payable	45,800	
Debt	218,000	
Cash		263,800
[To record debt payment]		
Retained earnings	30,000	
Dividends payable		30,000
[To record declaration of $.50 per share dividend on the 60,000 allocated shares]		
Compensation expense	190,000	
Dividends payable	30,000	
Paid-in capital		20,000
Unearned ESOP shares		200,000
[To record release of 20,000 shares (17,273 for compensation and 2,727 for dividends) at an average fair value of $11.00 per share (shares cost ESOP $10 per share)]		
Provision for income taxes	737,680	
Paid-in capital	4,000	
Deferred tax asset		7,200
Income taxes payable		734,480
[To record income taxes for year 4, see tax computations following journal entries]		

Year 5

Interest expense	24,000	
Accrued interest payable		24,000
[To record interest expense]		
Accrued interest payable	24,000	
Debt	239,800	
Cash		263,800
[To record debt payment]		
Retained earnings	40,000	
Dividends payable		40,000
[To record declaration of $.50 per share dividend on the 80,000 allocated shares]		

(Continued)

Compensation expense	224,000	
Dividends payable	40,000	
Paid-in capital		64,000
Unearned ESOP shares		200,000

[To record release of 20,000 shares (16,970 for compensation and 3,030 for dividends) at an average fair value of $13.20 per share (shares cost ESOP $10 per share)]

Provision for income taxes	790,400	
Deferred tax asset		15,920
Income taxes payable		774,480

[To record income taxes for year 5, see tax computations following journal entries]

Illustration of Termination

Assuming Company A terminates its ESOP at the end of year 2 (when the fair value of the suspense shares is $540,000 [60,000 shares multiplied by $9 per share], the unearned compensation balance is $600,000, and the unpaid debt balance is $656,000), and assuming the suspense shares are sold to pay down the debt, Company A would make the following journal entry:

Debt	656,000	
Additional paid-in capital	60,000	
Unearned ESOP shares		600,000
Cash		116,000

[To record repayment of the ESOP's loan and termination of the plan]

Tax and EPS Computations

The following tables set forth Company A's tax (assuming no termination) and EPS computations:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(215,000)	(195,000)	(170,000)	(190,000)	(224,000)
Pretax income	1,485,000	1,621,400	1,764,400	1,864,200	1,952,000
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Shareholders' equity	-0-	-0-	4,000*	(4,000)*	-0-
Total	600,000	646,560	697,760	737,680	790,400
Net income	$ 885,000	$ 974,840	$1,066,640	$1,126,520	$1,161,600
Average shares outstanding	1,010,000	1,030,000	1,050,000	1,070,000	1,090,000
Earnings per share	$ .88	$ .95	$ 1.02	$ 1.05	$ 1.07

* See paragraph 50. In year 3, the amount is calculated as follows: 20,000 shares released multiplied by $.50 excess cost over average fair value per share multiplied by 40 percent tax rate.

Tax Computations

	Year 1	Year 2	Year 3	Year 4	Year 5
Current provision:					
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
ESOP contribution	(213,800)	(213,800)	(213,800)	(213,800)	(213,800)
ESOP dividends	(50,000)	(50,000)	(50,000)	(50,000)	(50,000)
Taxable income	1,536,200	1,636,200	1,736,200	1,836,200	1,936,200
Multiplied by 40 percent	$ 614,480	$ 654,480	$ 694,480	$ 734,480	$ 774,480
Deferred provision:					
Reduction in unearned ESOP shares for financial reporting	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Related tax deduction*	163,800	180,200	198,200	218,000	239,800
Difference	(36,200)	(19,800)	(1,800)	18,000	39,800
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/(benefit)	$ (14,480)	$ (7,920)	$ (720)	$ 7,200	$ 15,920

* This amount is the principal repayment.

Reconciliation of Effective Tax Rate to Provision for Income Taxes

Pretax income	$1,485,000	$1,621,400	$1,764,400	$1,864,200	$1,952,000
Tax at 40 percent (statutory rate)	594,000	648,560	705,760	745,680	780,800
Benefit of ESOP dividends	-0-	(4,000)	(8,000)	(12,000)	(16,000)
Effect of difference between average fair value and cost of released shares	6,000	2,000	-0-	4,000	25,600
Provision as reported	$ 600,000	$ 646,560	$ 697,760	$ 737,680	$ 790,400

Illustrative Disclosure for End of Year 3

The company sponsors a leveraged employee stock ownership plan (ESOP) that covers all U.S. employees who work twenty or more hours per week. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to active employees, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the debt of the ESOP is recorded as debt and the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for earnings-per-share (EPS) computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest. ESOP compensation expense was $170,000, $195,000, and $215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	Year 3	*Year 2*
Allocated shares	40,000	20,000
Shares released for allocation	20,000	20,000
Unreleased shares	40,000	60,000
Total ESOP shares	100,000	100,000
Fair value of unreleased shares at December 31,	$400,000	$540,000

ILLUSTRATION 2

Common Stock Leveraged ESOP Used to Fund the Employer's Match of a 401(k) Savings Plan With an Indirect Loan

Assumptions

On January 1, Year 1, Company B established an ESOP to fund the employer's match of its savings plan as follows:

- All of the assumptions are the same as those for Company A, except as follows.
- Company B loaned its ESOP $1,000,000 and concurrently obtained a related loan. The terms of both lending arrangements are the same as for Company A's outside loan.
- Company B uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The average fair value of the shares for each year is used to determine the number of shares necessary to satisfy the matching obligation.
- If the fair value of the shares released is less than Company B's matching obligation, Company B contributes additional newly issued shares to the ESOP to satisfy the remaining obligation.
- Shares used to replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

Table 2-a

Year	*Employee Contributions*	*Employer Match*	*Number of Shares*
1	$400,000	$200,000	18,605
2	410,000	205,000	20,000
3	420,000	210,000	22,105
4	430,000	215,000	19,545
5	440,000	220,000	16,667

Note: The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock [for year 1: $200,000 divided by $10.75 (See table 1-a for average fair values) equals 18,605 shares].

- The 20,000 shares released each year based on debt service payments follow:

Table 2-b

Year	*Number of Shares Needed to Settle 401(k) Liability*	*Total ESOP Shares Released*	*ESOP Shares Used for Dividends*	*ESOP Shares Available to Settle 401(k) Liability*	*Compensation (Additional Shares)*	*Top-Up (Additional Shares)*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1	18,605	20,000	-0-	20,000	1,395	-0-
2	20,000	20,000	976	19,024	-0-	976
3	22,105	20,000	2,105	17,895	-0-	4,210
4	19,545	20,000	2,727	17,273	-0-	2,272
5	16,667	20,000	3,030	16,970	303	-0-

Notes:

(1) See table 2-a.

(2) See assumptions.

(3) See table 1-c.

(4) Total ESOP shares released minus ESOP shares used for dividends.

(5) If the ESOP shares needed to settle the 401(k) liability (column 1) are less than the ESOP shares available to settle the liability (column 4), then the remaining shares are considered compensation (this is the case in years 1 and 5).

(6) If the ESOP shares needed to settle the 401(k) liability (column 1) are greater than the ESOP shares available to settle the liability (column 4), then the shortfall must be made up by the employer in the form of top-up shares (this is the case in years 2, 3, and 4).

- Cumulative share amounts follow:

Table 2-c

Year	*Cumulative Number of Shares Released*	*Cumulative Number of Shares Allocated*	*Total Suspense Shares*
1	20,000	-0-	80,000
2	40,976	20,000	60,000
3	65,186	40,976	40,000
4	87,458	65,186	20,000
5	107,458	87,458	-0-

Note: Dividends on top-up shares are paid in cash. Cumulative shares released include top-up shares.

Results of Applying SOP

The following table sets forth Company B's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense ESOP*	*Compensation Expense Top-Up*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*	*(7)*
1	$ 163,800	$ (200,000)	$ (15,000)	$ -0-	$100,000	$215,000	$ -0-	$ (263,800)
2	180,200	(200,000)	(15,000)	10,000	83,600	195,000	10,000	(263,800)
3	198,200	(200,000)	(30,000)	20,500	65,600	170,000	40,000	(264,300)
4	218,000	(200,000)	(45,000)	32,600	45,800	190,000	25,000	(266,400)
5	239,800	(200,000)	(64,000)	43,700	24,000	224,000	-0-	(267,500)
Total	$1,000,000	$(1,000,000)	$(169,000)	$106,800	$319,000	$994,000	$75,000	$(1,325,800)

Notes:

(1) See table 1-b.

(2) Number of shares released during the year (20,000) multiplied by the cost per share to ESOP ($10).

(3) Number of shares released during the year (20,000) multiplied by the difference between average fair value per share (see table 1-a) and cost per share to the ESOP ($10) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the top-up.

(4) Cumulative shares allocated (see table 2-c) multiplied by the dividend per share ($.50).

(5) Number of ESOP shares released for direct compensation plus number of shares released related to employer's match of 401(k) (see table 2-b) multiplied by the average fair value per share (see table 1-a).

(6) Additional shares contributed (top-up) to satisfy the 401(k) obligation (see table 2-b) multiplied by the fair value of shares contributed.

(7) The cash disbursed to the ESOP each year is composed of $213,800 contribution; $50,000 in dividends on original ESOP shares; and dividends on top-up shares of $500 in year 3, $2,600 in year 4, and $3,700 in year 5.

Journal Entries

Company B would record journal entries from inception through year 2 as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record loan]		
Unearned ESOP shares (equity)	1,000,000	
Common stock and additional paid-in capital		1,000,000
[To record the issuance of 100,000 shares to the ESOP at $10 per share]		

Year 1

Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		
Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800
[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, none of which was charged to retained earnings in year 1, and $213,800 supplemental cash contribution to the ESOP)]		
Compensation expense	200,000	
401(k) liability		200,000
[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]		
401(k) liability	200,000	
Compensation expense	15,000	
Unearned ESOP shares		200,000
Paid-in capital		15,000
[To record release of 20,000 shares at an average fair value of $10.75 per share, 18,605 shares are used to satisfy 401(k) liability and the remaining 1,395 are used to compensate participants directly (shares cost ESOP $10 per share)]		
Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480
[To record income taxes for year 1 (See illustration 1 for detailed tax computation)]		

(Continued)

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $50,000 in dividends, $10,000 of which was charged to retained earnings in year 2, and $213,800 supplemental cash contribution to the ESOP)]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to employer's 401(k) match, which represents 50 percent of employee contributions]

Retained earnings	10,000	
Dividends payable		10,000

[To record declaration of $.50 per share dividend on the 20,000 allocated shares]

401(k) liability	205,000	
Dividends payable	10,000	
Unearned ESOP shares		200,000
Common stock/paid-in capital		15,000

[To record release of 20,000 shares plus contribution of an additional 976 shares to the ESOP at an average fair value of $10.25 per share, 20,000 shares are used to satisfy 401(k) liability and the remaining 976 shares are used to replace dividends on allocated shares used for debt service (shares cost ESOP $10 per share)]

Deferred tax asset	7,920	
Provision for income taxes	642,560	
Income taxes payable		650,480

[To record income taxes for year 2 (See illustration 1 for detailed tax computation)]

Note: Journal entry differs from Illustration 1 because Company B receives an additional $10,000 deduction ($4,000 tax benefit) for the 976 top-up shares.

Illustration of Termination

Assuming Company B terminated its ESOP at the end of year 4 (when the fair value of the suspense shares is $240,000, the unearned ESOP shares balance is $200,000, and the unpaid debt balance is $239,800), and assuming the employer buys back the suspense shares in an amount equal to the debt balance, there will be seventeen suspense shares left, which must be allocated to participants. (In this illustration the shares are used to partially satisfy the employer's 401(k) matching obligation.) Company B would make the following journal entry:

Treasury stock	239,800	
401(k) liability	204	
Additional paid-in-capital		40,004
Unearned ESOP shares		200,000

[To record repurchase of ESOP suspense shares and termination of the plan]

Debt	239,800	
Cash		239,800

[To record repayment of the ESOP's loan]

Tax and EPS Computations

Company B's taxes would be computed the same way as Company A's. For Company B the average number of ESOP shares outstanding would be as follows:

Year	*ESOP Shares Outstanding*
1	10,000
2	30,488
3	53,081
4	76,322
5	97,458

This represents the cumulative numbers of shares released at the beginning of the year plus the end of the year (see table 2-c) divided by 2.

Illustrative Disclosure for End of Year 3

The company sponsors a 401(k) savings plan under which eligible U.S. employees may choose to save up to 6 percent of salary income on a pre-tax basis, subject to certain IRS limits. The company matches 50 percent of employee contributions with company common stock. The shares for this purpose are provided principally by the company's employee stock ownership plan (ESOP), supplemented as needed by newly issued shares. The company makes annual contributions to the ESOP equal to the ESOP's debt service less dividends received by the ESOP. All dividends received by the ESOP are used to pay debt service. The ESOP shares initially were pledged as collateral for its debt. As the debt is repaid, shares are released from collateral and allocated to employees who made 401(k) contributions that year, based on the proportion of debt service paid in the year. The company accounts for its ESOP in accordance with Statement of Position 93-6. Accordingly, the shares pledged as collateral are reported as unearned ESOP shares in the statement of financial position. As shares are released from collateral, the company reports compensation expense equal to the current market price of the shares, and the shares become outstanding for EPS computations. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense for the 401(k) match and the ESOP was $210,000, $205,000, and $215,000 for years 3, 2, and 1, respectively. The ESOP shares as of December 31 were as follows:

	Year 3	*Year 2*
Allocated shares	40,976	20,000
Shares released for allocation	24,210	20,976
Unreleased shares	40,000	60,000
Total ESOP shares	105,186	100,976
Fair value of unreleased shares at December 31	$400,000	$540,000

Common Stock Nonleveraged ESOP

Assumptions

On January 1, Year 1, Company C established a nonleveraged ESOP as follows:

- Company C contributed 10 percent of pretax profit before ESOP-related charges to the ESOP at the end of each of years 1 through 5; the ESOP bought newly issued employer stock with the contribution.
- The number of shares, earnings, tax, and other relevant assumptions are the same as those for Company A.

Results of Applying SOP

The following chart sets forth Company C's ESOP-related information:

Year	*Compensation Expense*	*Dividends*	*Number of ESOP Shares Purchased*	*Cumulative ESOP Shares*
1	$180,000	$ -0-	15,652	15,652
2	190,000	7,830	21,111	36,763
3	200,000	18,380	20,000	56,763
4	210,000	28,380	17,500	74,263
5	220,000	37,130	15,278	89,541

The year-end market value is used in this illustration to determine the number of ESOP shares purchased. [Year 1: $180,000 divided by $11.50 (See table 1-a) equals 15,652]

Journal Entries

Company C would record journal entries for years 1 and 2 as follows:

Year 1

Compensation expense	180,000	
Common stock/paid-in capital		180,000

[To record contribution, sale of shares, and compensation expense]

(Continued)

Provision for income taxes	648,000	
Income taxes payable		648,000

[To record income taxes at 40 percent for year 1 on earnings of $1,620,000 ($1,800,000 pre-ESOP income less ESOP compensation of $180,000)]

Year 2

Compensation expense	190,000	
Retained earnings	7,830	
Common stock/paid-in capital		190,000
Dividends payable		7,830

[To record contribution, sale of shares, declaration of dividends, and compensation expense]

Dividends payable	7,830	
Cash		7,830

[To record payment of dividends]

Provision for income taxes	684,000	
Income taxes payable		684,000

[To record income taxes at 40 percent for year 2 on earnings of $1,710,000 ($1,900,000 pre-ESOP income less ESOP compensation of $190,000)]

Convertible Preferred Stock Leveraged ESOP With a Direct Loan

Assumptions

On January 1, Year 1, Company D established an ESOP with convertible preferred stock as follows:

- The borrowing, debt service, earnings, and tax assumptions are the same as those for Company A.
- On January 1, Year 1, the ESOP used the proceeds of the debt to buy 80,000 shares of newly issued convertible preferred stock of Company D for $12.50 per share.
- The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the ESOP's shares). Accordingly, in this illustration the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- All dividends on ESOP shares are used for debt service.
- The preferred stock is convertible into common stock at 1:1 ratio.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at $13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 4-a

Year	*Year-end*	*Average*
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

- The shares released each year follow:

Table 4-b

Year	*Dividends*	*Compensation*	*Total Released*	*Total Allocated*
1	0	16,000	16,000	-0-
2	1,600	14,400	16,000	16,000
3	3,200	12,800	16,000	16,000
4	4,800	11,200	16,000	16,000
5	6,061	9,939	16,000	16,000

Note: The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (16,000 multiplied by $1.25 in year 2; 32,000 multiplied by $1.25 in year 3; etc.) by the average fair value of a share of preferred stock ($12.50 in years 2 and 3). In this illustration the remaining shares are released for compensation (16,000 less 1,600 in year 2, 16,000 less 3,200 in year 3, etc.).

- Additional share information follows:

Table 4-c

Year	*Cumulative Number of Shares* *Released*	*Allocated*	*Year-End Suspense Shares*
1	16,000	-0-	64,000
2	32,000	16,000	48,000
3	48,000	32,000	32,000
4	64,000	48,000	16,000
5	80,000	64,000	-0-

Results of Applying SOP

The following chart sets forth Company D's ESOP-related information. All amounts represent changes (credits in parentheses) in account balances.

Year	*Principal*	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends*	*Interest Expense*	*Compensation Expense*	*Cash*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(5)*	*(6)*
1	163,800	$ (200,000)	$ -0-	$ -0-	$100,000	$200,000	$ (263,800)
2	180,200	(200,000)	-0-	20,000	83,600	180,000	(263,800)
3	198,200	(200,000)	-0-	40,000	65,600	160,000	(263,800)
4	218,000	(200,000)	-0-	60,000	45,800	140,000	(263,800)
5	239,800	(200,000)	(11,200)	80,000	24,000	131,200	(263,800)
Total	$1,000,000	$(1,000,000)	$(11,200)	$200,000	$319,000	$811,200	$(1,319,000)

Notes:

(1) See table 1-b

(2) Total number of shares released during the year (16,000) multiplied by the cost per share to ESOP ($12.50).

(3) Total number of shares released during the year (16,000) multiplied by the difference between average fair value per share at the release date (see table 4-a) and cost-per-share to the ESOP ($12.50).

(4) Cumulative shares allocated (see table 4-c) multiplied by the dividend per share ($1.25).

(5) Total number of ESOP shares released for compensation (see table 4-b) multiplied by the average fair value per share to ESOP (see table 4-a).

(6) The cash disbursed each year is composed of $163,800 in contributions and $100,000 in dividends.

Journal Entries

The journal entries to reflect the accounting for Company D's ESOP from inception through year 2 are as follows:

January 1, Year 1 (inception)

Cash	1,000,000	
Debt		1,000,000
[To record the ESOP's loan]		
Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000
[To record the issuance of shares to the ESOP]		

Year 1

Interest expense	100,000	
Accrued interest payable		100,000
[To record interest expense]		
Accrued interest payable	100,000	
Debt	163,800	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 consists of $100,000 in dividends, none of which was charged to retained earnings in year 1, and $163,800 supplemental cash contribution to the ESOP)]

(Continued)

Compensation expense	200,000	
Unearned ESOP shares		200,000

[To record release of 16,000 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share)]

Deferred tax asset	14,480	
Provision for income taxes	600,000	
Income taxes payable		614,480

[To record income taxes for year (See tax computations following journal entries)]

Year 2

Interest expense	83,600	
Accrued interest payable		83,600

[To record interest expense]

Accrued interest payable	83,600	
Debt	180,200	
Cash		263,800

[To record debt payment (The cash disbursement of $263,800 is made up of $100,000 in dividends, $20,000 of which was charged to retained earnings in year 2, and $163,800 supplemental cash contribution to the ESOP)]

Retained earnings	20,000	
Dividends payable		20,000

[To record declaration of $1.25 per share dividend on the 16,000 allocated shares]

Compensation expense	180,000	
Dividends payable	20,000	
Unearned ESOP shares		200,000

[To record release of 16,000 shares at an average fair value of 12.50 per share (shares cost ESOP $12.50 per share)]

Deferred tax asset	7,920	
Provision for income taxes	646,560	
Income taxes payable		654.480

[To record income taxes for year (See tax computations following journal entries)]

Tax and EPS Computations

The tax and EPS calculations for Company D follow:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	(100,000)	(83,600)	(65,600)	(45,800)	(24,000)
Compensation expense	(200,000)	(180,000)	(160,000)	(140,000)	(131,200)
Pretax income	1,500,000	1,636,400	1,774,400	1,914,200	2,044,800
Provision for income tax					
Currently payable	614,480	654,480	694,480	734,480	774,480
Deferred	(14,480)	(7,920)	(720)	7,200	15,920
Total	$ 600,000	$ 646,560	$ 693,760	$ 741,680	$ 790,400
Net income	$ 900,000	$ 989,840	$1,080,640	$1,172,520	$1,254,400
Preferred stock dividends	-0-	20,000	40,000	60,000	80,000
Earnings applicable to common stock	$ 900,000	$ 969,840	$1,040,640	$1,112,520	$1,174,400
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
EPS without conversion	$ .90	$ .97	$ 1.04	$ 1.11	$ 1.17
EPS if converted primary and fully diluted	$ .89	$ .95	$ 1.01	$ 1.07	$ 1.13

(Continued)

If-converted computation:

	Year				
	1	*2*	*3*	*4*	*5*
Earnings applicable to common stock	$ 900,000	$ 969,840	$1,040,640	$1,112,520	$1,174,400
Add—					
Preferred dividends net of tax	-0-	12,000	24,000	36,000	48,000
Tax benefit on "as if" converted common dividend (1)	-0-	3,902	8,421	10,909	12,800
Less—					
Additional compensation (2)	-0-	(6,146)	(11,368)	(19,636)	(28,800)
Adjusted earnings	$ 900,000	$ 979,596	$1,061,693	$1,139,793	$1,206,400
Shares outstanding					
Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if converted (3)	9,302	29,268	52,632	63,636	72,000
Total	1,009,302	1,029,268	1,052,632	1,063,636	1,072,000
If converted EPS—primary and fully diluted*	$ .89	$ .95	$ 1.01	$ 1.07	$ 1.13

* For year 2, the end of year price of the common stock is less than the average price. In accordance with paragraph 32, the fully diluted EPS computation should reflect the year-end stock price. In this illustration, both the primary and fully diluted EPS computations round to the same amount.

Computations for (1), (2), and (3) follow:

	Year				
	1	*2**	*3*	*4*	*5*
(1) Allocated preferred shares	-0-	16,000	32,000	48,000	64,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted allocated common shares	-0-	19,512	42,105	54,545	64,000
Dividends at $.50 per common share	$ -0-	$ 9,756	$21,053	$27,273	$32,000
Tax benefit on common dividends	$ -0-	$ 3,902	$ 8,421	$10,909	$12,800
(2) Preferred dividends at $1.25 per share	$ -0-	$20,000	$40,000	$60,000	$80,000
Dividends at $.50 per common share	$ -0-	(9,756)	(21,053)	(27,273)	(32,000)
Additional compensation gross	$ -0-	$10,244	$18,947	$32,727	$48,000
Net of tax	$ -0-	$ 6,146	$11,368	$19,636	$28,800
(3) Computation Average preferred shares released	8,000	24,000	40,000	56,000	72,000
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If converted average released common shares	9,302	29,268	52,632	63,636	72,000

* For year 2, the end of year price of the common stock is less than the average price. In accordance with paragraph 32, the fully diluted EPS computation should reflect the year-end stock price. In this illustration, both the primary and fully diluted EPS computations round to the same amount.

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year				
	1	*2*	*3*	*4*	*5*
Pretax income	$1,500,000	$1,636,400	$1,774,400	$1,914,200	$2,044,800
Tax at 40 percent (Statutory rate)	$ 600,000	$ 654,560	$ 709,760	$ 765,680	$ 817,920
Benefit of ESOP dividends	-0-	(8,000)	(16,000)	(24,000)	(32,000)
Effect of difference between fair value and cost of released shares	-0-	-0-	-0-	-0-	4,480
Provision as reported	$ 600,000	$ 646,560	$ 693,760	$ 741,680	$ 790,400

Convertible Preferred Stock Leveraged ESOP Used to Fund a 401(k) Savings Plan With an Employer Loan

Assumptions

On January 1, Year 1, Company E established a leveraged ESOP with convertible preferred stock as follows:

- The ESOP borrowed $1,000,000 from the employer at 10 percent for five years and used the proceeds to buy 80,000 shares of newly issued convertible preferred stock of Company E for $12.50 per share.
- Debt service is funded by cash contributions and dividends on employer stock held by the ESOP.
- Dividends on all of the original 80,000 shares held by the ESOP are used for debt service.
- Cash contributions are made at the end of each year.
- The preferred stock pays dividends quarterly at an annual rate of $1.25 per share ($100,000 each year for the ESOP's shares). Accordingly, in this illustration, the average fair value of the shares is used to determine the number of shares used to satisfy the employer's obligation to replace dividends on allocated shares used for debt service.
- The preferred stock is convertible at a 1:1 ratio into common stock.
- Participants may not withdraw the convertible preferred stock from the ESOP. When participants become eligible to withdraw shares from their account, they must either convert to common stock or redeem the preferred shares.
- The preferred stock has a guaranteed minimum redemption value of $12.50 per share, to be paid in shares of common stock.
- The preferred stock is callable at $13.00 per share.
- There is one vote per preferred share.
- The year-end and average fair values of a share of preferred stock (fair value is assumed to be greater than or equal to minimum value) follow:

Table 5-a

Year	*Year-end*	*Average*
1	$12.50	$12.50
2	12.50	12.50
3	12.50	12.50
4	12.50	12.50
5	14.40	13.20

- Company E uses shares released by the ESOP to satisfy its matching obligation of 50 percent of voluntary employee contributions to the savings plan. The fair value of the shares at the end of each month is used to determine the number of shares necessary to satisfy the matching obligation. (Accordingly, in this illustration, average fair values are used to determine the number of shares needed to satisfy the employer's liabilities.)
- If the fair value of the shares released is less than Company E's matching obligation, Company E contributes additional newly issued shares (top-up shares) to the ESOP to satisfy the remaining obligation. The top-up shares are issued at the end of the year. Dividends on the top-up shares are paid in cash.
- Shares that replace dividends on allocated shares used to service debt do not count toward the employer's match.
- The employee contributions, required employer match, and the number of shares needed to fund the employee match follow:

Table 5-b

Year	*Employee Contributions*	*Employer Match*	*Number of Shares*
1	$400,000	$200,000	16,000
2	410,000	205,000	16,400
3	420,000	210,000	16,800
4	430,000	215,000	17,200
5	440,000	220,000	16,667

Note: The number of shares needed to satisfy the employer's matching obligation is determined by dividing the matching obligation by the average fair value of a share of common stock (for year 1: $200,000 divided by $12.50 equals 16,000 shares).

- Principal and interest are payable in annual installments at the end of each year. Debt service is as follows:

Table 5-c

Year	*Principal*	*Interest*	*Total Debt Service*
1	$ 110,000	$100,000	$ 210,000
2	150,000	89,000	239,000
3	200,000	74,000	274,000
4	250,000	54,000	304,000
5	290,000	29,000	319,000
Total	$1,000,000	$346,000	$1,346,000

- Shares are released from the suspense account for allocation to participants' accounts based on a principal-plus-interest formula. The released shares are allocated to participants' accounts at the beginning of the following year. Shares are assumed to be released ratably throughout the year.
- The shares released each year follow:

Table 5-d

Year	*Number of Shares Needed to Satisfy 401(k) Liability*	*Total Released*	*Shares Released for Dividends*	*ESOP Shares Available to Satisfy 401(k) Liability*	*Additional Shares (Top-Up)*
1	16,000	12,481	-0-	12,481	3,519
2	16,400	14,205	1,248	12,957	3,443
3	16,800	16,286	2,669	13,617	3,183
4	17,200	18,068	4,297	13,771	3,429
5	16,667	18,960	5,780	13,180	3,487

Note: The number of shares released for dividends is determined by dividing the amount of dividends on allocated shares (12,481 multiplied by $1.25 in year 2; 26,686 multiplied by $1.25 in year 3, etc.) by the average fair value of a share of preferred stock ($12.50 in years 2 and 3). In this illustration, the remaining shares are released for compensation (14,205 less 1,248 in year 2; 16,286 less 2,669 in year 3, etc.).

- Additional share information follows:

Table 5-e

	Initial ESOP Shares Cumulative Shares		*Top-Up Shares Cumulative Shares*				
Year	*Released*	*Allocated*	*Issuable*	*Issued*	*Average Shares Released/ Issuable*	*Total Shares Allocated*	*Year-end Suspense Shares*
1	12,481	0	3,519	0	8,000	0	67,519
2	26,686	12,481	6,962	3,519	24,824	16,000	53,314
3	42,972	26,686	10,145	6,962	43,383	33,648	37,028
4	61,040	42,972	13,574	10,145	63,866	53,117	18,960
5	80,000	61,040	17,061	13,574	85,838	74,614	0

- The pre-ESOP income, shares outstanding, and income tax assumptions are the same as for illustrations 1 through 4.

Results of Applying SOP

The following chart sets forth Company E's ESOP-related information. All amounts represent changes (credits are in parentheses) in account balances.

Year	*Unearned ESOP Shares*	*Paid-In Capital*	*Dividends—Original Shares*	*Dividends—Top-Up Shares*	*Compensation Expense ESOP*	*Compensation Expense Top-Up*
Notes	*(1)*	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1	$ (156,000)	$ (44,000)	$ -0-	$ -0-	$156,000	$ 44,000
2	(177,600)	(43,000)	15,600	4,400	162,000	43,000
3	(203,600)	(39,800)	33,400	8,700	170,200	39,800
4	(225,800)	(42,900)	53,700	12,700	172,100	42,900
5	(237,000)	(59,300)	76,300	17,000	174,000	46,000
Total	$(1,000,000)	$(229,000)	$179,000	$42,800	$834,300	$215,700

Notes:

(1) Total number of shares released during the year multiplied by the cost per share to ESOP ($12.50).

(2) Total number of shares released during the year multiplied by the difference between average fair value per share at the release date (see table 5-a) and cost per share to the ESOP ($12.50) plus the additional paid-in capital that arises from the top-up shares contributed, which equals the compensation expense related to the ESOP.

(3) Cumulative shares allocated from original 80,000 shares (see table 5-e) multiplied by the dividend per share ($1.25).

(4) Cumulative top-up shares issued (see table 5-e) multiplied by the dividend per share ($1.25).

(5) Total number of ESOP shares released for compensation (see table 5-d) multiplied by the average fair value per share (see table 5-a).

(6) Top-up shares (see table 5-d) multiplied by the average fair value per share (see table 5-a).

Journal Entries

The journal entries to reflect the accounting for Company E's ESOP from inception through year 2 are as follows:

January 1, Year 1 (inception)

Unearned ESOP shares (equity)	1,000,000	
Preferred stock		1,000,000

[To record the issuance of shares to the ESOP]

Year 1

Compensation expense	200,000	
401(k) liability		200,000

[To record cost and liability related to 401(k) match]

401(k) liability	200,000	
Preferred stock		44,000
Unearned ESOP shares		156,000

[To record release of 12,481 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share) and issuance of 3,519 additional shares at $12.50 per share for top-up]

Deferred tax asset	18,400	
Provision for income taxes	600,000	
Income tax payable		618,400

[To record income taxes for year 1 (See tax computations following journal entries)]

Year 2

Retained earnings	15,600	
Dividends payable		15,600

[To record declaration of $1.25 per share dividend on the 12,481 allocated shares]

Retained earnings	4,400	
Cash		4,400

[To record declaration and payment of $1.25 per share dividend on the 3,519 issued top-up shares]

Compensation expense	205,000	
401(k) liability		205,000

[To record cost and liability related to 401(k) match]

(Continued)

401(k) liability	205,000	
Dividends payable	15,600	
Unearned ESOP shares		177,600
Preferred stock		43,000

[To record release of 14,205 shares at an average fair value of $12.50 per share (shares cost ESOP $12.50 per share) and issuance of 3,443 additional shares at $12.50 per share for top-up]

Deferred tax asset	11,040	
Provision for income taxes	636,160	
Income tax payable		647,200

[To record income taxes for year 2 (See tax computations following journal entries)]

Tax and EPS Computations

The tax and EPS computations for Company E follow:

	Year				
	1	*2*	*3*	*4*	*5*
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
Interest expense	100,000	89,000	74,000	54,000	29,000
Compensation—ESOP	156,000	162,000	170,200	172,100	174,000
Compensation—top-up	44,000	43,000	39,800	42,900	46,000
Pretax income	1,500,000	1,606,000	1,716,000	1,831,000	1,951,000
Provision for income tax					
Currently payable	618,400	647,200	674,480	701,240	734,000
Deferred	(18,400)	(11,040)	(1,440)	9,680	21,200
Total	600,000	636,160	673,040	710,920	755,200
Net income	900,000	969,840	1,042,960	1,120,080	1,195,800
Preferred stock dividends	0	20,000	42,100	66,400	93,300
Earnings applicable to common stock	$ 900,000	$ 949,840	$1,000,860	$1,053,680	$1,102,500
Common shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
EPS without conversion	$.90	$.95	$1.00	$1.05	$1.10
EPS if converted primary and fully diluted	$.89	$.93	$.97	$1.01	$1.06

If-Converted EPS Computation

	Year				
	1	*2**	*3*	*4*	*5*
Earnings applicable to common shares	$900,000	$949,840	$1,000,860	$1,053,680	$1,102,500
Add—					
Preferred dividends net of tax	0	12,000	25,260	39,840	55,980
Tax benefit on "as if" converted common dividend (1)	0	3,902	8,855	12,072	14,923
Less—					
Additional compensation (2)	0	4,795	9,481	17,579	27,468
Adjusted earnings	$900,000	$960,947	$1,025,494	$1,088,013	$1,145,935
Shares outstanding					
Non-ESOP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
ESOP as if-converted (3)	9,302	30,273	57,083	72,575	85,838
Total	1,009,302	1,030,273	1,057,083	1,072,575	1,085,838
If-converted EPS—primary and fully diluted*	$.89	$.93	$.97	$1.01	$1.06

*For year 2, the end of year price of the common stock is less than the average price. In accordance with paragraph 32, the fully diluted EPS computation should reflect the year-end stock price. In this illustration, both the primary and fully diluted EPS computations round to the same amount.

(Continued)

Calculation 1:					
Allocated and issued preferred shares	0	16,000	33,648	53,117	74,614
Conversion ratio	1:1	1:1	1:1	1:1	1:1
Redemption ratio	12.50/10.75	12.50/10.25	12.50/9.50	12.50/11.00	1:1
If-converted allocated and issued common shares	0	19,512	44,274	60,360	74,614
Dividends at $.50 per common share	$0	$9,756	$22,137	$30,180	$37,307
Tax benefit on common dividends	$0	$3,902	$8,855	$12,072	$14,923
Calculation 2:					
Allocated preferred shares (excluding top-up shares)	0	12,481	26,686	42,972	61,040
Preferred dividends at $1.25 per share	$0	$15,601	$33,358	$53,715	$76,300
If-converted allocated common shares (excluding top-up shares)	0	15,221	35,113	48,832	61,040
Dividends at $.50 per common share	$0	$ 7,610	$17,557	$24,416	$30,520
Additional compensation					
Gross	$0	$7,991	$15,801	$29,299	$45,780
Net of tax	$0	$4,795	$9,481	$17,579	$27,468
Calculation 3:					
Average preferred shares released and issuable	8,000	24,824	43,383	63,866	85,838
If-converted average released and issuable common shares	9,302	30,273	57,083	72,575	85,838

Tax Computation

	Year				
	1	*2*	*3*	*4*	*5*
Current provision:					
Income before ESOP	$1,800,000	$1,900,000	$2,000,000	$2,100,000	$2,200,000
ESOP contribution	110,000	139,000	174,000	204,000	219,000
ESOP dividends	100,000	100,000	100,000	100,000	100,000
Top-up contribution	44,000	43,000	39,800	42,900	46,000
Taxable income	1,546,000	1,618,000	1,686,200	1,753,100	1,835,000
Tax rate	40%	40%	40%	40%	40%
	618,400	647,200	674,480	701,240	734,000
Deferred provision:					
Reduction in unearned ESOP shares	156,000	177,600	203,600	225,800	237,000
Related tax deduction	110,000	150,000	200,000	250,000	290,000
Difference	(46,000)	(27,600)	(3,600)	24,200	53,000
Tax rate	40%	40%	40%	40%	40%
Deferred tax expense/(benefit)	(18,400)	(11,040)	(1,440)	9,680	21,200
Total provision	$ 600,000	$ 636,160	$ 673,040	$ 710,920	$ 755,200

Reconciliation of Effective Tax Rate to Provision for Income Taxes

	Year				
	1	*2*	*3*	*4*	*5*
Pretax income	$1,500,000	$1,606,000	$1,716,000	$1,831,000	$1,951,000
Tax at 40 percent	600,000	642,400	686,400	732,400	780,400
Benefit of ESOP dividends	0	(6,240)	(13,360)	(21,480)	(30,520)
Effect of difference between fair value and cost of released shares	0	0	0	0	5,320
Provision as reported	$ 600,000	$ 636,160	$ 673,040	$ 710,920	$ 755,200

APPENDIX B

Discussion of Comments Received on Exposure Draft

An exposure draft of a proposed statement of position, "Employers' Accounting for Employee Stock Ownership Plans," was issued for public comment in December 1992 and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Sixty-five comment letters were received on the exposure draft.

The most significant and pervasive comments received were in three areas: (*a*) measurement of compensation cost, (*b*) pro forma disclosures, and (*c*) effective date.

Measurement of Compensation Cost

A majority of respondents asked AcSEC to reconsider, for some or all ESOPs, the requirement in the SOP that the fair value of shares committed to be released be used to measure compensation cost. Many of them supported the minority view in this SOP. Three primary objections were raised in the comment letters.

The most frequent reason stated in comment letters for objecting to the proposed measurement of compensation was that debt payments or contributions, that is the cash payments, are a better measure of the value of employees' services than the fair value of shares released.

The second most frequent reason for objecting was disagreement with the argument in the proposed SOP that the risks and rewards of ownership of the shares rest with the employer, not the employees, until the shares are committed to be released. Some respondents disagreed with that statement in general. Other respondents disagreed with a related notion that employers have control over the employees' total compensation package and can make changes in other parts of compensation in response to unanticipated changes in the value of the unreleased shares. Most of those making those arguments support the minority view—that is, they believe that the risks and rewards remain with the employer for type II ESOPs, but believe that is not the case for type I ESOPs.

AcSEC had considered such arguments during the process leading up to the exposure draft, and continues to believe that the reasons for measuring compensation cost based on the fair value of the shares when committed to be released as stated in paragraph 70 of the SOP support its conclusion. Furthermore, AcSEC notes that the conclusion on measurement of compensation cost is consistent with AcSEC's fundamental conclusion that the debt and shares related to ESOP transactions should be accounted for separately. AcSEC believes that the fact that employers may, and often do, establish internally leveraged ESOPs that involve no net cash flows by the employer to the ESOP (the financing element is eliminated), supports its view that the fair value of shares when released is a more relevant measure of the employee's services than the value of the shares when they are placed in an ESOP trust. From the employer's perspective, the economic substance of such transactions is that shares are placed in a trust and released to employees over time; no net cash is ever disbursed or received.

AcSEC continues to believe that the risks and rewards of ownership of the unreleased shares remain with the employer, even when there is no explicit use of the fair value of the shares in determining whether the employer has satisfied an obligation. Though many commentators said that employers do not adjust other compensation to reflect unanticipated changes in the fair value of employer shares, AcSEC has seen ESOP transactions in which the employer effectively controls compensation through its ability to control the debt terms and the rate at which shares are released. Further, AcSEC notes that many employers maintain control over the number of ESOP shares released through the ESOP loans with flexible terms, which allow for no or minimal principal payments before maturity and no prepayment penalties.

The third most frequent reason for objecting was that using the fair value of shares released penalizes companies whose share values increase and rewards companies whose share values decrease. AcSEC believes that the important issue is whether the measure of compensation cost is appropriate, not whether the amount is more or less than it would be under a different method.

Pro Forma Disclosures

The proposed SOP would have required public companies that under the grandfathering provisions elected not to adopt the provisions of the SOP to disclose pro forma income before extraordinary items, net income, and EPS as if the employer had adopted the provisions of the SOP. Many respondents objected to those pro forma disclosures. The reasons most often cited for not requiring such disclosures follow:

- Such disclosures would add unnecessary complexity to the financial statements and would confuse rather than inform users.
- Such disclosures generally have not been required in the past for other accounting pronouncements with grandfathering provisions and would set a precedent for such disclosures in the future.
- Such disclosures are inconsistent with the grandfathering provisions and would discredit the amounts reported in the financial statements.
- The costs of making such disclosures would outweigh the benefits.

- It is unfair to require such disclosures only for public companies.

AcSEC found those arguments persuasive and deleted the disclosure requirement.

Effective Date

In the exposure draft the grandfathering cutoff date was September 23, 1992, the date the FASB cleared the proposed SOP for exposure. Many respondents noted that a later date connected with a year end would be more appropriate. In response to those comments the cutoff date was changed to December 31, 1992.

Many respondents considered the effective date for years ending on or before December 15, 1993, in the exposure draft unreasonable. AcSEC agreed and extended the effective date by one year.

APPENDIX C

Law Changes

The following is a list of the most significant revisions to laws concerning ESOPs since 1976.

- The tax deduction limits were expanded from 15 percent of pay to 25 percent of pay, plus interest in certain cases.[1] This change prompted more small companies to use ESOPs and larger companies to increase the portion of employee benefits covered by ESOPs.
- ESOP sponsors were permitted to deduct dividends paid on ESOP shares from taxable income if the dividends were applied to debt service or distributed to plan participants.[2] This change increased the economic appeal of leveraged ESOPs. For example, it increased the amount of debt that could be covered for employers whose compensation base was too low to amortize the ESOP debt under the contribution limits of the Internal Revenue Code (IRC).
- Under certain circumstances, a person who sold stock to an ESOP was permitted to defer income tax on any resulting gain by reinvesting the sales proceeds in other corporate securities.[3] This change contributed to the substantial increase in the number of ESOPs sponsored by non-traded companies.
- Commercial lenders were permitted to exclude from taxable income 50 percent of the interest they earned on certain ESOP securities acquisition loans.[4] This change resulted in a reduced financing rate on such loans, as lenders frequently passed a portion of the savings on to their customers. Many new ESOP loans were made as a result of this change. (Although 1989 legislation significantly limited this benefit, all of the prior loans were allowed to retain their tax advantages.)
- The regulatory requirement that if ESOPs buy outstanding shares, the purchase must be tested under the corporate redemption rules was eliminated.[5] The significance of this development was that the IRC recognized the independence of ESOPs from their sponsors if certain controls are in place. Thus, it increased the usefulness of ESOPs in transfers of ownership of closely held companies.

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[1] IRC Sections 404(a)(9) and 415(c)(6).

[2] IRC Section 404(k).

[3] IRC Section 1042.

[4] IRC Section 133.

[5] Rev. Proc. 87-22, which superseded Rev. Procs. 77-30, 78-18, and 78-23.

APPENDIX D

Impact of SOP on Current ESOP Guidance

Current Guidance	*Impact of SOP*
FASB Statement No. 87, *Employers' Accounting for Pensions*	The SOP includes accounting guidance on nonleveraged ESOPs that is consistent with the guidance for defined contribution plans in Statement No. 87.
AICPA SOP 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*	The SOP supersedes SOP 76-3. However, under the transition provisions in the proposed SOP, employers may continue their current accounting practices for ESOP shares purchased before December 31, 1992.
EITF Issue No. 85-11, *Use of an Employee Stock Ownership Plan in a Leveraged Buyout*	No consensus was reached on this issue by the EITF. However, for ESOP shares accounted for under the SOP, the issue is moot, because compensation cost is measured based on the fair value of shares when committed to be released.
EITF Issue No. 86-4, *Income Statement Treatment of Income Tax Benefit for Employee Stock Ownership Plan Dividends*	FASB Statement No. 109, *Accounting for Income Taxes*, nullified this consensus. The SOP deals with issues related to accounting for income taxes.
EITF Issue No. 86-27, *Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan*	The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased in a pension reversion occurring before December 31, 1992.
EITF Issue No. 87-23, *Book Value Stock Purchase Plans*	This EITF topic includes three issues; only the third one relates to ESOPs. The SOP, which is consistent with the consensus, supersedes this consensus on the third issue. However, under the transition provisions in the SOP, employers may continue their current

Current Guidance	*Impact of SOP*
	accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.
EITF Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*	The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted starting on page 77.
EITF Issue No. 89-8, *Expense Recognition for Employee Stock Ownership Plans*	The SOP supersedes this consensus. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.
EITF Issue No. 89-10, *Sponsor's Recognition of Employee Stock Ownership Plan Debt*	The SOP, which is consistent with this consensus, supersedes the consensus.
EITF Issue No. 89-11, *Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*	The SOP does not deal with this issue and accordingly does not supersede the consensus. The consensus is reprinted starting on page 79.
EITF Issue No. 89-12, *Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan*	The SOP supersedes these consensuses. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus applies to employers making that election.
EITF Issue No. 90-4, *Earnings-per-Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan*	FASB Statement No. 109, *Accounting for Income Taxes*, nullified this consensus.

(Continued)

Current Guidance	*Impact of SOP*
EITF Issue No. 92-3, *Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan*	Under this SOP, dividends paid on unallocated shares are not charged to retained earnings. However, under the transition provisions in the SOP, employers may continue their current accounting for shares purchased before December 31, 1992. This consensus would apply to employers making that election.
ETIF Issue No. 93-2, *Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations*	The SOP does not deal with this issue and accordingly does not supersede this consensus. The consensus is reproduced starting on page 81.

EITF Abstracts

Issue No. 88-27

Title: Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations

Date Discussed: January 12-13, 1989

References: APB Opinion No. 16, *Business Combinations*
AICPA Accounting Interpretation 20, *Treasury Stock Allowed with Pooling,* of APB Opinion No. 16
AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*
SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*
SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in regard to Accounting Series Release No. 146*

ISSUE

Employee stock ownership plans (ESOPs) may hold shares of the sponsoring entity that are not allocated to the participants in the plan. Those unallocated shares may be allocated later or, under certain limited circumstances, may be sold or disposed of otherwise by the ESOP. Unlike allocated shares that must be reallocated to remaining plan participants if a participant leaves the plan before the shares become vested, the unallocated sponsoring entity shares held by the ESOP are not required to remain within the ESOP or with its participants. Further, to the extent the ESOP acquires unallocated shares as a result of a pension plan termination, Issue No. 86-27, "Measurement of Excess Contributions to a Defined Contribution Plan or Employee Stock Ownership Plan," requires unallocated shares held by the ESOP to be reported as treasury shares by the sponsoring entity.

The issue is under what circumstances, if any, unallocated sponsoring entity shares held by an ESOP should be considered tainted treasury shares for purposes of determining whether the pooling-of-interests method of accounting is appropriate for a business combination.

EITF DISCUSSION

The Task Force reached a consensus that unallocated shares held by an ESOP should not be considered tainted for purposes of determining whether the pooling-of-interests method of accounting is appropriate unless (1) there is more than a remote possibility that such shares could revert to the sponsoring entity, (2) there exists an agreement or intent, either written or implicit, whereby the sponsoring entity will repurchase or reacquire shares from the ESOP or from an employee that receives shares in a distribution (except if required by law to provide liquidity to the plan participant), or (3) the shares were acquired to circumvent the requirements of Opinion 16.

The Task Force considered comments by a tax partner of an accounting firm that generally, for unallocated shares in an ESOP, the possibility of those shares reverting to the sponsoring entity is remote. Some Task Force members noted that the relevant attributes of unallocated shares differ for purposes of determining whether the shares are treasury shares, as addressed in Issue 86-27, compared with whether those treasury shares are tainted, as addressed in this Issue.

STATUS

No further EITF discussion is planned.

Issue No. 89-11

Title: Sponsor's Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

Dates Discussed: September 21, 1989; December 14, 1989

References: APB Opinion No. 25, *Accounting for Stock Issued to Employees*
SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*

ISSUE

Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an employee stock ownership plan (ESOP) and that are not readily tradeable on an established market must include a put option. The put option is a right to demand that the sponsor redeem shares of employer stock held by the participant for which there is no market for an established cash price. The employer may have the option to issue marketable securities for all or a portion of that option rather than to pay cash. The provisions of the ESOP may permit the ESOP to substitute for the sponsor as buyer of the employer stock; however, in no case can the sponsor require the ESOP to assume the obligation for the put option.

The issue is, in a leveraged ESOP, if securities subject to a put option are classified outside of permanent equity, whether any of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*) should be similarly classified.

EITF DISCUSSION

The Task Force reached a consensus that when ASR 268 (as presented in Section 211 of the "Codification of Financial Reporting Policies") requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section of the sponsor's balance sheet (sometimes described as *loan to ESOP* or *deferred compensation*), if any, should be similarly classified.

The SEC Observer indicated that ASR 268 requires that to the extent that there are conditions (regardless of their probability of occurrence) whereby holders of equity securities may demand cash in exchange for their securities, the sponsor must reflect the maximum possible cash obligation related to those securities outside of permanent equity. Thus, securities held by an ESOP (whether or not allocated) must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash. With respect to ESOP securities where the cash obligation relates only to market value guarantee features, the SEC staff would not object to registrants only classifying outside of permanent equity an amount that represents the maximum cash obligation of the sponsor based on market prices of the underlying security as of the reporting date; accordingly, reclassifications of equity amounts would be required based on the market values of the underlying security. Alternatively, the SEC staff would not object to classifying the entire guaranteed value amount outside of permanent equity due to the uncertainty of the ultimate cash obligation because of a possible market value decline in the underlying security.

STATUS

No further EITF discussion is planned.

EITF Abstracts

Issue No. 93-2

Title: Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations

Date Discussed: January 21, 1993

References: APB Opinion No. 16, *Business Combinations*
AICPA Accounting Interpretation 20, *Treasury Stock Allowed with Pooling*, of APB Opinion No. 16
AICPA Statement of Position 76-3, *Accounting Practices for Certain Employee Stock Ownership Plans*
AICPA Proposed Statement of Position, *Employers' Accounting for Employee Stock Ownership Plans*, dated December 21, 1992
SEC Accounting Series Release No. 146, *Effect of Treasury Stock Transactions on Accounting for Business Combinations*
SEC Accounting Series Release No. 146A, *Statement of Policy and Interpretations in Regard to Accounting Series Release No. 146*

ISSUE

An employer (Company) establishes an irrevocable grantor trust (Trust) to prefund certain employee benefits. The Company sells shares of its stock to the Trust in return for a note payable and, at or about the same time, reacquires treasury shares. Alternatively, the Trust may acquire Company shares in the marketplace using funds borrowed from the Company. The shares will be released from the Trust in future periods as debt is repaid or forgiven and will be used to meet obligations of the Company to various employee benefit plans.

The issue is whether Company shares reacquired coincident with the establishment of the Trust, either by the Company or by the Trust, should be considered tainted shares for purposes of pooling-of-interests accounting under Opinion 16.

EITF DISCUSSION

The SEC Observer stated that it is the SEC staff's position that Issue No. 88-27, "Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations," and Topic No. D-19, "Impact on Pooling-of-Interests Accounting of Treasury Shares Acquired to Satisfy Conversions in a Leveraged Preferred Stock ESOP," in *EITF Abstracts* Appendix D, addressed ESOPs that are defined contribution employee benefit plans, as contemplated by SOP 76-3.[1] An ESOP that funds other employee benefit plans was not contemplated by either Issue 88-27 or Topic D-19.[2]

The SEC staff believes that the application of the consensus in Issue 88-27 and the statements made in Topic D-19 should be limited to "Type I" ESOPs. However, the SEC staff will not object to the application of the consensus in Issue 88-27 and Topic D-19 for shares held by a "Type II" ESOP as of January 21, 1993, provided the respective criteria are satisfied. Shares purchased by a Type II ESOP subsequent to January 21, 1993 would be considered treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

The SEC Observer also stated that the trust arrangement described in this Issue is neither a Type I nor a Type II ESOP. Therefore, the SEC staff's position is that shares acquired in the past or in the future and placed in trust to fund future corporate obligations, such as the trust vehicle described in this Issue, are treasury stock directly acquired by the employer and presumed to be tainted shares for the purpose of applying the provisions of paragraph 47(d) of Opinion 16.

Because of the SEC staff's position, the Task Force did not discuss this Issue.

STATUS

No further EITF discussion is planned.

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[1]This type of ESOP arrangement has been characterized as a Type I ESOP in the proposed Statement of Position on employers' accounting for employee stock ownership plans:

> *Type I*—shares are released to compensate employees directly. Such ESOPs are not used to fund other employee benefits and the fair value of the shares at the time of release is not a factor at the time of release. These ESOPs are the typical ESOPs that existed at the time SOP 76-3 was issued.

[2]This type of ESOP arrangement has been characterized as a Type II ESOP in the proposed Statement of Position:

> *Type II*—shares are released to settle or fund liabilities for other specified or determinable employee benefits, such as an employer's match of a 401(k) plan. The fair value of shares released is used to determine how many shares are needed to satisfy an obligation that arose outside the ESOP.

Glossary

This glossary contains definitions of certain terms used in employers' accounting for ESOP transactions.

Allocated shares. The shares in an ESOP trust that have been assigned to individual participant accounts based on a known formula. IRS rules require allocations to be nondiscriminatory generally based on compensation, length of service, or a combination of both. For any particular participant such shares may be vested, unvested, or partially vested.

Committed-to-be-released shares. The shares that, although not legally released, will be released by a future scheduled and committed debt service payment and will be allocated to employees for service rendered in the current accounting period. The period of employee service to which shares relate is generally defined in the ESOP documents. Shares are legally released from suspense and from serving as collateral for ESOP debt as a result of payment of debt service. Those shares are required to be allocated to participant accounts as of the end of the ESOP's fiscal year. Formulas used to determine the number of shares released can be based on either (*a*) the ratio of the current principal amount to the total original principal amount (in which case unearned ESOP shares and debt balance will move in tandem) or (*b*) the ratio of the current principal plus interest amount to the total original principal plus interest to be paid. Shares are released more rapidly under the second method than under the first. Tax law permits the first method only if the ESOP debt meets certain criteria.

Dividends on previously allocated shares used for debt service. The allocation of shares to participant accounts that replaces the cash dividends on allocated shares that were or will be used for debt service. Under the IRC, dividends on shares held by an ESOP that have been allocated to participant accounts cannot be used for debt service unless the employers allocate shares to those participants whose dollar value is no less than the dollar value of the dividends that were used for debt service. (The IRS has not issued guidance on what employers would be required to do to make up the difference between the value of any dividends withdrawn and the shares allocated. In practice, plan sponsors apply a wide variety of techniques to satisfy the Code requirements.)

Suspense shares. Shares that have not been released, committed to be released, or allocated to participant accounts. Suspense shares generally collateralize ESOP debt.

Top-up shares. The shares or cash that an employer contributes to an ESOP because the fair value of the shares released is less than the employer's liability for a particular benefit, such as a savings plan match.

Vested shares. Allocated shares for which a participant's right to receive the shares or redeem the shares for cash is no longer contingent on remaining in the service of the employer. Allocated shares that have not been vested may be forfeited if a participant terminates his or her employment and reallocated to other participants. Whether the shares in a participant's ESOP account are vested depends on the length of that employee's service and the vesting provisions of the ESOP. The Code specifies minimum vesting requirements for benefits attributable to employer contributions. Currently, the Code permits two minimum vesting approaches:

a. Graded vesting, under which employees vest 20 percent after three years of service and 20 percent for each additional year of service until they become 100 percent vested.

b. Cliff vesting, under which employees vest 100 percent after five years of service.

Accordingly, the shares allocated to participants at any date will include shares that are fully vested, shares that are not vested, and (if graded vesting is used) shares that are partially vested.

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